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Uno Faces Challenging Summit

Prime Minister Sosuke Uno was sitting tight and lying low prior to heading to the July 14-16 summit meeting of leaders from the major industrial nations. His low-profile demeanor stemmed from a plethora of domestic events that have undermined what might have been a position of strength at the summit considering that until about one month ago he was foreign minister in the cabinet of former Prime Minister Noboru Takeshita. Among Mr. Uno's handicaps:

- He was regarded as a decided "second choice" to succeed Prime Minister Takeshita. On top of his relatively weak domestic political power base (he is the only prime minister in the Liberal Democratic Party's 34-year history who is not a faction head), Mr. Uno was viewed skeptically because of his prominent position in the faction headed by former Prime Minister Yasuhiro Nakasone, who was tainted in the Recruit Co., Ltd. scandal. Ruling party elders chose Mr. Uno in the hope that his noninvolvement with Recruit, political seniority and diplomatic experience could restore public faith in the LDP and begin to stabilize the domestic political climate in anticipation of the July 23 upper house elections.

- He became the target less than a week into his administration of reports of sexual liaisons with geishas. This episode, coming so closely on the

currency fluctuations, but he did not agree to any specific measures. Rather, he simply stated that Japan will address the problem.

ASEAN officials also repeated an oft-heard request that Japan increase its investment in the region. Although Japanese firms have expanded their presence in Southeast Asia significantly in the past five years (see Figure), ASEAN members want more investment to take the form of joint ventures with local firms. They also have urged Japan to establish manufacturing rather than assembly ventures so that Southeast Asian countries can acquire the necessary technologies to promote economic development.

In short, the issues addressed at the Brunei conference were hardly new. Cambodia, Pacific cooperation and Japan-ASEAN economic relations have been discussed repeatedly in recent years. But the participants were well aware that they are closer now than they have been in a long while to making substantial progress on at least two of the issues: Cambodian peace and a Pacific Rim organization. At the very least, they have begun to discuss the types of frameworks they will need to formulate specific agreements.

Eileen M. Doherty

FY 1990 Spending Guidelines Set

Getting a jump on politically significant domestic and international events, the cabinet of Prime Minister Sosuke Uno approved guidelines July 11 for the fiscal 1990 general account budget. After initial consultations with major ministries, the Ministry of Finance clamped down hard on discretionary spending so a FY 1990 issue of deficit financing bonds will be unnecessary. Significant exceptions to this tough spending rule will help to translate the budget outline into a second year of moderate fiscal stimulus.

MOF is rushing preparations for the FY 1990 fiscal budget out of a concern that the government and the ruling Liberal Democratic Party will be too engrossed in political developments later this summer to devote full attention to the budget. Both the cabinet of Prime Minister Uno and other members of the LDP are reeling from the effects of the Recruit Co., Ltd. influence-buying affair and charges of private misconduct by Mr. Uno. The LDP lost a prefectural governorship that previously was considered safe and took a beating in recent Tokyo municipal elections (see JEI Reports No. 25B, June 30, 1989, and No. 26B, July 7, 1989). Political commentators now are focusing on the summit of leading industrial nations, which opens July 14, and the July 23 elections for the upper house of the Diet.

In the meantime, MOF has proposed that central government outlays for public works and other investments in the April 1990-March 1991 period be frozen at FY 1989 levels. Expenditures for administration and all other operations are to be cut by 10 percent, according to the MOF spending plan. As it has in the past MOF will exempt certain spending categories from its budget knife, including defense, foreign aid, pensions, personnel and science and technology promotion. This strict regime, MOF hopes, will allow the central government to avoid issuing more deficit-financing bonds. Flotations of this type of bond (as opposed to bonds tied specifically to public works projects) have declined rapidly over the past three fiscal years, falling from nearly Y5

trillion ($35.6 billion at Y140=$1.00) in FY 1987 to under Y3.2 trillion ($22.5 billion) in FY 1988 and to an estimated Y1.3 trillion ($9.5 billion) in the current fiscal period (see JEI Report No. 19A, May 12, 1989).

The Finance Ministry contends that this moderate spending policy will not affect overall economic growth adversely. Consumer spending and private nonresidential capital formation are expected to continue to drive domestic demand. MOF points to the decidedly mild reaction by the business community and consumers to the 0.75 percentage point increase in the Bank of Japan's discount rate as evidence of the expansion's robustness.

After consulting with the ministers of construction, health and welfare and foreign affairs as well as the head of the Japan Defense Agency, MOF submitted to the cabinet guidelines that will allow the following increases compared with the initial FY 1989 budget (see Table):

- Pensions will lead the increases, growing by Y520 billion ($3.7 billion) to Y11.4 trillion ($81.5 billion). The 4.8 percent increase represents over half of the growth in total discretionary spending.

- Defense spending will increase 6.4 percent or Y249 billion ($1.8 billion) to nearly Y4.2 trillion ($29.8 billion).

- Official development assistance will jump 9.4 percent or Y71 billion ($507.1 million) to Y826.7 billion ($5.9 billion).

FY 1989 and FY 1990 Initial General Account Budget Guidelines

(change from previous year in billions of yen)

	FY 1989	FY 1990
Discretionary Expenditures	Y910	Y1,032
Defense	227	249
Annual defense expenditures due to international treaties	148	131
Personnel	104	150
Social Welfare	505	560
Official development assistance	66	71
Energy measures	104	44
Annual science and technology expenditures due to international treaties	16	17
Special programs	70	170
Disaster preparedness	30	20
Administrative expenses	-360	-380
Capital investment	0	0
Proceeds from the Sale of NTT Shares	1,300	1,300
Public enterprises	1,200	1,230
Private enterprises	100	70

Source: Nihon Keizai Shimbun

Overall discretionary spending will rise 3 percent to Y35.1 trillion ($250.8 billion), just under FY 1989's 3.3 percent increase. This is a little lower than the Finance Ministry had expected; its initial soundings of other agencies yielded a 3.2 percent gain over current budget levels. Since this figure applies only to discretionary spending (total spending minus debt service payments and mandatory revenue-sharing with local governments), overall spending growth could be much higher. (In FY 1989 the total budget was 6.6 percent higher, for example.)

Under normal political circumstances all ministries and agencies would submit their initial budget requests by the end of August, and a final budget would be prepared by December. With the results of the upper house elections and the future of the Uno cabinet in doubt, MOF is trying to build extra time into the budget process should political affairs disrupt the normal process as they did in delaying final passage of the FY 1989 spending package. Election results unsettling to the ruling LDP could, however, force new budget priorities on MOF; repeal of the unpopular 3 percent general consumption tax is a widely discussed possibility. Even more than previous years, therefore, the preliminary budget guidelines must be seen as just that, preliminary.

Jon Choy

Surging Private Capital Spending Grabs Increased Share Of Funds

One of the most remarkable features of Japan's ongoing economic expansion has been the explosive growth in private plant and equipment spending, which has reached near-record levels in recent quarters (see JEI Report No. 26B, July 7, 1989). The means of financing this capital spending has shown commensurate expansion, with consequences for the rest of the economy.

Recently released Bank of Japan flow-of-funds statistics tell the story (see Table). These data describe the net position in financial terms of the

Japan's Financial Balance by Sector

(percent of nominal GNP)

	1965-74	1975-84	1983	1984	1985	1986	1987	1988
Corporate Business	-7.1%	-2.9%	-3.0%	-1.7%	-1.9%	-1.3%	-2.2%	-4.6%
Personal	9.4	10.3	10.3	9.8	9.8	10.2	7.9	7.6
Public	-2.6	-7.1	-6.8	-5.8	-4.2	-4.2	-1.4	0.6
Overseas	-0.7	-0.8	-1.8	-2.8	-3.6	-4.3	-3.6	-2.8
Balance*	1.0	0.5	1.3	0.5	-0.1	-0.4	-0.7	-0.8

*Rounding error and financial institutions.

Note: Minus indicates financial deficit (sector is net borrower from rest of economy).

Source: Bank of Japan

business, personal, government, financial institutions and foreign sectors of the Japanese economy. In effect, the sectors can be thought of as borrowing and lending to each other. The personal sector in Japan traditionally has a large surplus, a consequence of high household savings rates. The foreign sector, by contrast, in recent years has been a net borrower, indicating in part the huge capital outflow to the United States. Together, reflecting the principles of double-entry bookkeeping, all the sectoral imbalances add up to zero. In other words, the sources of funds by definition equal the uses of funds.

As corporations have increased their plant and equipment spending, they increasingly have pulled in funds from outside their sector. Financing from the other sectors increased among corporate businesses from a low of 1.3 percent of gross national product in calendar 1986 to 4.6 percent of GNP in 1988. But corporations were not alone in demanding more funds. Booming demand for mortgages in 1987 and 1988 was one of the main factors suppressing the flow of funds out of the household sector into others. As the table shows, the personal sector's surplus relative to GNP has declined sharply in the two most recent years.

With individuals and households supplying less, and corporations demanding more funds relative to GNP, changes in the public sector and the foreign sector made up the difference. (The net inflow into the remaining category, financial institutions, was small and changed little.) In everyday language, this implied that the government's budget deficit and the trade surplus both shrank relative to GNP in 1987 and 1988. The net supply of funds to foreigners declined to 2.8 percent of GNP in 1988, continuing a decline that began after a peak of 4.3 percent of GNP was reached in 1986.

The changed direction of funds was even more striking in the public sector. According to BOJ's broad-based measures, the government's net position -- including public corporations, local governments as well as the central government -- moved into surplus in 1988 for the first time since 1961. (Between 1962 and 1974 the central government generally was in surplus but not by enough to offset deficits at the local government level and in public corporations.) In 1988 the overall public-sector surplus came to 0.6 percent of GNP.

Japanese analysts attribute this somewhat surprising result to two factors. First, tax revenues grew rapidly, reflecting the expansion of the economy. Second, Tokyo has a long-term policy of restraining expenditures in order to rein in the deficit (see preceding article).

The BOJ figures are only one way of measuring the shift in the government's budget position. Recent estimates for Japan by the Organization for Economic Cooperation and Development and the Bank for International Settlements, which are based on data from the Economic Planning Agency, tell a story very similar to that of the BOJ data. According to the OECD and BIS figures, the central and local governments' budget position, including social security, registered a surplus in 1987 for the first time since 1974. This black ink is estimated to have reached 1.3 percent of GNP in 1988, a level high enough to make Japan number-three among the 24 OECD countries after Sweden and Norway. By comparison, the net U.S. federal, state and local government deficit, while improved in 1987 and 1988 from previous levels, still reached almost 2 percent of GNP. As recently as 1979, the United States managed a government budget surplus as measured by this OECD yardstick.

International comparisons, of course, are open to many criticisms. For example, additions to social security funds reduce government deficits or raise surpluses in many countries but should be treated separately for various purposes. In this case, however, their inclusion is appropriate to capture the fiscal impact of government spending.

Tracing cause and effect through the imbalances is difficult. For instance, the combination of a budget surplus in Japan with a trade surplus says little by itself about causation. In this case, as noted above, corporate demand for funds has been an important third factor. Through the end of 1988, at least, the surge in plant and equipment spending more than offset the emerging budget surplus, keeping interest rates higher than otherwise. Relatively tight money, in turn, restrained the flow of capital out of Japan, keeping the yen stronger than otherwise. As a result, exports were weaker, imports stronger and the current account surplus smaller than it probably would have been in the absence of the capital spending boom.

Will this pattern of intersector flow of funds and related international transactions persist in 1989? That depends, in part, on what one believes about capital spending in Japan. If, as expected, it rises moderately, then the 1988 pattern could be repeated, with little change in sectoral imbalances. But, if corporate spending should collapse, all bets are off on the direction of the yen and the trade balance. In a worst-case scenario for international economic policymakers in Tokyo and Washington, the improvement in the competitive position of Japanese firms that results from the new plant and equipment spending could coincide with a drop in that spending. Given the improbability that the government would acquiesce to budget deficits after struggling for so long to reduce them, investments abroad would take on more appeal. This, in turn, would pose unpleasant policy implications for the yen, which could fall, and the current account surplus, which could rise.

Douglas Ostrom

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.